Staff Testimony on:

DEMAND CONFORMANCE CRITERIA FOR *ER 96*

Prepared for the July 16-18, 1996 ***ER 96*** Committee Hearing

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INTRODUCTION

The purpose of this testimony is to address a question contained in Section III. B. of the February 15, 1996 ***ER 96*** Issues Order:

> "What are the appropriate need conformance criteria for applications for certification (AFCs) and small powerplant exemptions (SPPEs) filed during the pendency of ***ER 96***?"

Further, Public Resources Code section 25308.5 requires that:

> "In developing the electricity report, the commission shall, after providing an opportunity for parties to submit recommendations, establish criteria for determining demand conformance for the siting of facilities."

The terms "Need Conformance" and "Demand Conformance" are used interchangeably.

Staff's overarching principle regarding Demand Conformance for ***ER 96*** is that because ***ER 94*** was adopted barely eight months ago, and has not yet been tested in an actual siting case, the Demand Conformance policies for ***ER 96*** should acknowledge, generally continue, and build on those of ***ER 94***. Among the significant Demand Conformance precepts established in ***ER 94*** that staff believes are worthy of carrying forward to ***ER 96*** are:

- ***ER 94*** noted the changes that have occurred in the electricity industry since the CEC was formed, detailed the changing rationale for need determinations during that period, and listed the fostering of competition among many suppliers as one of its key objectives.

- Fostering a competitive market, in which the financial risk associated with a new powerplant is borne by the plant developer rather than captive ratepayers, means barriers to market entry must be eliminated. Thus, ***ER 94*** stated:

  > "To the extent that recovery of project costs is not guaranteed by ratepayers, the rationale for government's determination of the need for the facility from an electricity supply perspective evaporates. (***ER 94***, p.51)
  >
  > ...with a competitive market on the horizon, the need assessments of the past may not be protecting ratepayers - rather, they may be a barrier to competitive options. (***ER 94***, p. 132)
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  > In a well-functioning competitive industry, ratepayers would not be guaranteeing the profits of either utility or independent plants. And in order for such an industry to exist, government must remove itself, to the greatest extent feasible, as an obstacle to development of competition among suppliers. (***ER 94***, p. 132)

> We expect that most if not all new power plants will be built without any guarantee of cost recovery by captive ratepayers. In such situations there is no reason for government to impose a need test in order to protect those ratepayers. Indeed, to the extent that a need test stands in the way of development of new plants which could be built by entrepreneurs willing to compete, it would actually hurt ratepayers." (***ER 94***, p. 133)

The Commission has reaffirmed this policy position most recently in Chairman Charles Imbrecht's March 27, 1996 testimony to the Little Hoover Commission:

> "As the state moves through the transition to a market in which powerplant developers decide when and where it makes economic sense to build new facilities--and take the risk themselves that those judgments may be wrong--the Commission's traditional role in reviewing the need for new facilities will continue to evolve and may eventually be phased out entirely."

- Based on the foregoing findings ***ER 94*** established a new category of non-utility-owned plants, called "Merchant Plants," and determined that they could all be found needed within individual siting cases so long as they did not cumulatively exceed one-half the statewide amount of capacity designated as "desirable acquisitions" (***ER 94***, p. 127) through the Integrated Assessment of Need (IAN.) The statewide need number identified in ***ER 94*** was 6,580 MW, with half, or 3,290 MW, apportioned to the Merchant Plant category, and half reserved for Utility-owned Plants. Staff proposes that the corresponding Statewide Need number for ***ER 96*** be 6,500 MW (see accompanying Resource Assessment testimony of Ross Miller, et al, dated June 18, 1996) and that it be allocated in the same way.

- ***ER 94*** generally distinguished between two types of plants: non-utility-owned, and utility-owned. Demand Conformance "tests" were essentially eliminated for the former, but retained for the latter, recognizing that utilities would continue to serve captive ratepayers for some time, and that they were likely to be the dominant firms in the market, thus warranting special vigilance. Staff proposes that this distinction be continued for ***ER 96*** for the limited purpose of imposing separate MW limits. As developers and utilities pursue creative financing arrangements, however, this distinction may become blurred.

Observance of the foregoing leads to the following proposed Need Conformance Criteria for ***ER 96***:

DEMAND CONFORMANCE CRITERIA FOR MERCHANT PLANTS

Staff proposes that ***ER 94***'s policy for Merchant Plants, defined as plants that are owned neither by a utility nor by an affiliate selling to an affiliated utility, be continued intact for ***ER 96***. All Merchant Plants are in conformance because of their competition-fostering attributes, and because they are presumed to impose no financial risks on captive ratepayers. No power purchase contracts are required. In keeping with the policy established in ***ER 94***, a MW limit (derived from the IAN) should be imposed on the Merchant Plant capacity that may be certified during ***ER 96***. Staff proposes that the limit continue to be one-half the IAN Statewide Need number, as it was in ***ER 94***. Staff testimony on Resource Assessments filed in ***ER 96*** on June 18, 1996 shows the statewide long-term capacity deficit to be 6,500 MW, using the mid-range DSM value. The capacity limit for Merchant Plants during ***ER 96*** would thus be 3,250 MW.

Plants owned by utility affiliates selling into the newly-proposed Power Exchange, or to any entity other than its affiliated utility, are considered Merchant Plants. No Demand Conformance criteria are necessary for plants owned by utility affiliates selling to their affiliated utility, as such self-dealing arrangements are prohibited by the CPUC. (See CPUC Decision D.95-12-063, 12/20/95, p. 71.) Plants owned by non-California utilities are considered Merchant Plants.

DEMAND CONFORMANCE CRITERIA FOR UTILITY-OWNED PLANTS

ER 94 did retain a need "Test" for plants proposed by utilities, in the form of a required economic evaluation. Staff is persuaded, however, that market forces, CPUC incentive regulation, municipal governing board oversight, and developments since the adoption of ***ER 94*** as described below, combine to provide sufficient ratepayer protection, and obviate the need for an economic evaluation within a siting case.

Market forces exert a discipline of their own. New investor-owned utility generation is not expected to be ratebased. Even municipal utilities, while not as directly affected by the threat of competition as investor-owned utilities, are not immune to competitive pressures and can be expected to be exceedingly cautious in entering into financial commitments. Staff is willing to risk reduced regulatory oversight in return for encouraging competition in the generation market.

In the months since ***ER 94*** was adopted, the CPUC has issued its major restructuring decision (D.95-12-063, 12/20/95) and the investor-owned utilities have made their first required filings at FERC, bringing the promise of competition closer to reality. Additionally, on July 15, 1996, the investor-owned utilities will be filing applications at the CPUC to institute performance-based ratemaking, as required by that decision. Combined, these actions signal a

continued movement away from traditional rate-of-return regulation, an expected shift of financial risk from ratepayers to stockholders, and a diminished role for the kind of ratepayer protection previously provided by the Commission's Need Tests.

Finally, ***ER 94*** raised concerns (p. 135) about the possible abuse of market power by dominant firms, and debated the establishment of a market power test, before deciding that such an action was premature and deferring the topic to ***ER 96***. While market power concerns remain, recent developments do provide assurances that the matter is being addressed. D.95-12-063 requests PG&E and Edison voluntarily to divest themselves of 50 percent of their fossil-fired generating capacity as a market power mitigation measure. Further, FERC will soon be conducting its own examination of the market power issue and may require mitigation of its own. Ultimately, as ***ER 94*** pointed out, the U.S. Justice Department protects consumers against undue market power through its enforcement of the federal antitrust laws. Collectively, staff believes these measures render the imposition of a market power test in an individual ***ER 96*** siting case to be premature. As a practical matter, since both PG&E and Edison assert that they will not be constructing any new generation for many years, the lack of a market power test carries little risk. Nevertheless, the Commission should continue to monitor the market power issue.

Therefore, for ***ER 96***, staff proposes that all utility-owned plants be found in conformance, up to the MW limit of one-half the IAN Statewide Need number, or 3,250 MW. Staff suggests, however, that the Commission reserve the right to reevaluate this position in subsequent Electricity Reports.

DEMAND CONFORMANCE CRITERIA FOR PLANTS SUBJECT TO STATUTORY NEED TESTS

ER 94 discussed (p. 137) two types of projects for which the Warren-Alquist Act prescribes special need tests: BRPU "results" and the results of other competitive solicitations. Since all such plants will either be Merchant Plants or Utility-owned Plants, they are already addressed above. Thus, this section of ***ER 94*** can be excluded from ***ER 96***.

DEMAND CONFORMANCE CRITERIA FOR DEMONSTRATION PROJECTS

Staff proposes that the substance of this section of ***ER 94*** be carried forward into ***ER 96*** intact.

DEMAND CONFORMANCE CRITERIA FOR SMALL POWER PLANT EXEMPTIONS

Staff proposes that the substance of this section of ***ER 94*** be carried forward into ***ER 96*** intact.

THE DIVERSITY SET-ASIDE

Testimony on diversity will be filed on July 30, 1996. It can not yet be determined whether the ***ER 96*** policy on diversity will have any implications for ***ER 96*** Demand Conformance criteria.

WHICH ELECTRICITY REPORT APPLIES?

Staff proposes that the substance of this section of ***ER 94*** be carried forward into ***ER 96*** intact.

Witness Qualifications
for
JAMES HOFFSIS

Mr. Hoffsis has been employed by the California Energy Commission (CEC) as an Electric Generation System Specialist in the Electricity Resource Assessment Office since January 1985. Mr. Hoffsis currently has oversight responsibility for Northern California resource assesments, out-of-state power and demand conformance issues. His prior CEC experience includes production cost modeling.

For the eight years before coming to CEC he was employed by the Florida Public Service Commission where he was primarily involved in the areas of cogeneration, avoided cost determination, power plant certification, fuel adjustment, and power plant productivity.

EDUCATION

B.S. in mathematics, Ohio State University.